89-1965

No. 89-________

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1989

COTTAGE SAVINGS ASSOCIATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

DENNIS L. MANES
Counsel of Record
SCOTT M. SLOVIN
SCHWARTZ, MANES & RUBY
2900 Carew Tower
441 Vine Street
Cincinnati, Ohio 45202
(513) 579-1414

ATTORNEYS FOR PETITIONER
COTTAGE SAVINGS ASSOCIATION

COURT INDEX PRESS, INC. — 215 E. Ninth Street, Cincinnati, Ohio 45202 — (513) 241-1450

QUESTION PRESENTED FOR REVIEW

I. Does Section 165 of the Internal Revenue Code, which limits the deduction of losses to those actually sustained, prevent the deduction by a savings institution of a realized and recognized loss on an exchange of different mortgage loan portfolios, where a regulation of the Federal Home Loan Bank Board permits the taxpayer to avoid recording the loss on its books for regulatory accounting purposes?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner respectfully requests that a Writ of Certiorari be issued to review the decision and judgment of the United States Court of Appeals for the Sixth Circuit entered on December 4, 1989, which reversed the decision of the United States Tax Court granting judgment in favor of Petitioner.

OPINIONS BELOW

The opinion of the Court of Appeals is contained in the Appendix at 1a, and is reported at 890 F.2d 848. The opinion of the Tax Court is contained in the Appendix at 16a, and is reported at 90 T.C. 372.

JURISDICTION

The judgment of the Court of Appeals was entered on December 4, 1989. A Petition for Rehearing was timely filed by the Petitioner on December 29, 1989. The Petition for Rehearing was denied on March 14, 1990. Jurisdiction to review

the judgment of the Sixth Circuit in this cause by a Writ of Certiorari is conferred on this Court by 28 U.S. Code Section 1254(1).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 165 *Losses*

(a) General rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

§ 1091 *Loss From Wash Sales of Stock or Securities*

(a) Disallowance of loss deduction. In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business. For purposes of this section, the term "stock or securities" shall, except as provided in regulations, include contracts or options to acquire or sell stock or securities.

Treasury Regulations on Income Tax (26 C.F.R.)

§ 1.165-1 (b)

(b) Nature of loss allowable. To be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable.

Substance and not mere form shall govern in determining a deductible loss.

§ 1.165-1 (d)

(d) Year of deduction. (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. . . . *[Remaining portions, which are not pertinent to sales or exchanges, are omitted]*

§ 1001-1 *Computation of gain or loss.*

(a) General rule. Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations

thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

STATEMENT OF THE CASE

Petitioner is a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes referred to as the "FHLBB"). On December 31, 1980, Petitioner exchanged some of its mortgage loans (more precisely, participations in such loans) for participations in mortgage loans owned by four unrelated savings and loan institutions located in the Cincinnati and Portsmouth, Ohio areas. The mortgage loans exchanged had declined in value because of increases in mortgage interest rates. As a result of these transactions, Petitioner deducted losses on its tax return for 1980, carried back said losses to earlier years (1974 through 1979), and recovered federal income taxes it had previously paid.

The Internal Revenue Service, disagreeing with Petitioner's tax treatment of this transaction (hereinafter sometimes referred to as "reciprocal mortgage loan transactions" or "reciprocal sales"), issued a statutory notice of deficiency to Petitioner on June 24, 1983, disallowing the deductions. Petitioner filed a petition in the United States Tax Court on September 23, 1983. A trial was held on June 18, 19 and 20, 1985 in Cincinnati.

On March 14, 1988, the Tax Court issued its opinion, reviewed by the entire court (two judges did not participate), holding for the Petitioner and sustaining Petitioner's loss on its reciprocal mortgage loan transactions. The Tax Court held that the Petitioner realized losses in the years under review and that the losses were recognized and deductible for income tax purposes. A decision was entered by the Tax Court on October 3, 1988.

From that judgment, the Internal Revenue Service took its appeal to the United States Court of Appeals for the Sixth Circuit by Notice of Appeal filed on December 30, 1988. After briefing and argument, the Court of Appeals rendered its opinion and judgment on December 4, 1989, reversing the judgment of the Tax Court.

The Court of Appeals agreed with the Tax Court that, in form, Petitioner's reciprocal sales produced an identifiable event that fixed a loss which was both realized and recognized for federal income tax purposes. However, it reversed because it said that no loss was sustained by Petitioner under Section 165 of the Internal Revenue Code.[1] A timely Petition for Rehearing was denied on March 14, 1990.

The basic facts in this case are fully set forth in detail in the Sixth Circuit and Tax Court opinions. As interest rates rose in the late 1970s, savings institutions were caught in a cash squeeze. Money was flowing into higher-yielding money market funds rather than to savings institutions as deposits. Even though their return from loans was low, the market required savings institutions to pay higher and higher interest rates in order to attract new deposits. Earnings declined as interest paid on deposits exceeded the interest earned on long-term fixed-rate mortgage loan portfolios.

Because of the increase in mortgage interest rates, the market values of existing fixed-rate mortgage loan portfolios held by savings institutions, including Petitioner, were substantially less than the book values of these portfolios. Even though Petitioner began offering adjustable rate mortgages in 1980, it continued to experience a drop in new loans as well as in deposits. Petitioner expected this decline in deposits to continue.

Petitioner could have sold its mortgage loan portfolios on the market and thus sustained a loss clearly deductible for federal income tax purposes. However, FHLBB regulations required Petitioner (and other federally insured savings and loan institutions) to meet certain net worth requirements. If Petitioner had merely sold the mortgage loans it transferred, and had been required by the FHLBB's regulatory accounting

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[1] Section 165 of the Internal Revenue Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise.

principles ("RAP") to reduce its net worth by the amount of losses it would have sustained on such a sale, the Petitioner's net worth would have been reduced to a level that barely exceeded the FHLBB's minimum requirement.

To relieve this dilemma, the FHLBB in 1980 promulgated a change in its accounting requirements known as "Memorandum R-49" ("R-49")[2]. Under R-49, institutions were no longer required to record such losses from the sale (and repurchase) of mortgage loans on their books. By observing R-49's criteria, savings institutions including Petitioner were encouraged to generate federal income tax refunds by entering into reciprocal sales transactions that produced deductible losses without impairing their net worth. R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical". The entire text of Memorandum R-49 is set forth in the Appendix. All of the mortgage loans involved in Petitioner's reciprocal sales satisfied the R-49 requirements.

Pursuant to R-49, on December 31, 1980, Petitioner entered into a series of Loan Participation Sale and Trust Agreements with four other savings institutions (three located in Cincinnati and one in Portsmouth, Ohio). In each transaction, checks were paid to and from Petitioner and its trading partners for the current fair market value of the mortgage loans (computed using an interest rate at December 31, 1980 of 14.863 percent). Petitioner then exchanged ninety percent mortgage participation interests in 252 of its mortgage loans and received in return ninety percent mortgage participations in 305 different loans from its trading partners.[3]

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[2] Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980).

[3] Sales of such participations are customary; and loans that are sold or purchased are usually sold or purchased in a group by savings and loans institutions. Participation interests are less liquid than whole loans so as a result of the December 31, 1980 transaction, Petitioner was in a less liquid position (except for its federal income tax refund) than before the transaction.

The participations sold and bought by Petitioner all were in loans that had different obligors, were "conventional" loans secured by mortgages on single-family residences, and were current. The underlying security (real estate) for each loan was different. The Tax Court found that the reciprocal mortgage loan transactions were motivated solely by the desire of Petitioner to recognize for tax purposes (but not regulatory purposes) the losses in market values of the loan portfolios it owned before the December 31, 1980 transactions. The Tax Court further found that the transactions at issue were between independent parties, were closed and completed, and were bona fide.

ARGUMENT

I. REASONS FOR ALLOWANCE OF THE WRIT OF CERTIORARI

This case presents a tax issue of first impression, one in which the Tax Court was in unanimity. The Sixth Circuit agreed with the decision of the Tax Court that Petitioner realized and recognized losses on its reciprocal sales of mortgage loans but held that Petitioner's losses were not deductible under Section 165 of the Internal Revenue Code because they were not sustained. On this issue as well as on the result in this case, the Sixth Circuit is in direct conflict with the Fifth Circuit and the District of Columbia Circuit, both of which affirmed decisions of the Tax Court in cases substantially similar to the instant case.

In *San Antonio Savings Association* v. *Commissioner*, 887 F.2d 577 (5th Cir. 1989), *aff'g*. 55 T.C.M. (CCH) 813 (1988), the Fifth Circuit Court of Appeals, on essentially the same facts as in this case[4], agreed with the Tax Court opinion in this case that the losses from reciprocal sales were realized, recognized and sustained. See also *Centennial Savings Bank FSB* v. *United States*, 887 F.2d 595 (5th Cir. 1989), *rev'g*. 682 F. Supp. 1389 (N.D. Tex. 1988) and *First Federal Savings and Loan Association of Temple* v. *United States*, 887 F.2d 593 (5th Cir. 1989), *aff'g*. 694 F. Supp. 230 (W.D. Tex. 1988).

The District of Columbia Circuit Court of Appeals in *Federal National Mortgage Association* v. *Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g*. 90 T.C. 405 (1988), on the same issue and on similar facts rejected "the Sixth Circuit's reasoning and result in favor of the more persuasive analysis of the Fifth Circuit and the Tax Court. . ." in this case. 896 F.2d at 584.

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[4] The facts in *San Antonio* are virtually identical to this case as *San Antonio* was decided by the Tax Court on summary judgment based on an assumption that the facts were essentially the same as in this case.

The ultimate decision in this case will affect dozens of savings institutions across the country which have engaged in transactions similar to that in issue here. Conservatively, hundreds of millions of dollars in tax refunds or payments will be affected by the decision in this case. The Tax Court thought this case sufficiently important that its decision was reviewed by the full court.

The reciprocal mortgage loan transaction entered into by Petitioner and its trading partners was completed at a time of crisis in the savings industry. Petitioner, as did savings institutions across the country, entered into this transaction to recognize the actual market-value loss on certain of its mortgage loans in order to generate tax refunds at a time in which savings institutions desperately needed cash to survive. Petitioner sold its mortgages and bought similar but different mortgages from other savings institutions pursuant to FHLBB Memorandum R-49 which was promulgated expressly to permit such reciprocal sales so that savings institutions could realize such market-value losses without impairing their net worth for regulatory accounting purposes.

II. QUESTION PRESENTED FOR REVIEW

Does Section 165 of the Internal Revenue Code, which limits the deduction of losses to those actually sustained, prevent the deduction by a savings institution of a realized and recognized loss on an exchange of different mortgage loan portfolios, where a regulation of the Federal Home Loan Bank Board permits the taxpayer to avoid recording the loss on its books for regulatory accounting purposes?

A. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165.

The Sixth Circuit concluded that Petitioner "realized" losses on the exchanges of its mortgages, that those losses must be "recognized," but that they were not deductible under Section 165 because they were not "sustained." This interpretation of the tax law is squarely contradicted by the Internal Revenue Service's own regulation and has been rejected by every other court that has considered mortgage exchange transactions. *See, e.g., San Antonio Savings Association* v. *Commissioner, supra* at 592-93.

The principal regulation dealing with gains and losses from sales and exchanges of property, Treas. Reg. Section 1.1001-1(a), explicitly states that if a taxpayer's amount realized from a sale or exchange is less than his adjusted basis in the property, "a loss *is sustained* to the extent of the difference between such adjusted basis and the amount realized." (Emphasis added.) In addition, the Regulation states that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss *sustained*." Treas. Reg. Section 1.1001-1(a). (Emphasis added.) Thus, according to the Regulation, so long as the property exchanged is

materially different, then every "realized" loss is "sustained".[5] The Tax Court held that the mortgage loans in this case were materially different, and that Petitioner's loss was thus "sustained". Nothing in Section 165 or the regulations thereunder is contrary to this conclusion.

B. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CONTRARY TO PRECEDENT.

The Sixth Circuit held that no losses had been sustained based on two findings: Petitioner (1) received "substantially identical" mortgages in the exchange and (2) did not record the losses on its books (*i.e.*, for nontax regulatory accounting purposes). Appendix at 14a. Both findings are unfounded and contrary to established authority.

With regard to its first finding, the Sixth Circuit apparently viewed the R-49 regulatory accounting criteria as determinative of when two groups of mortgages are "substantially identical" for tax purposes. This approach is directly contrary to *Hanlin* v. *Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g.* 38 B.T.A. 811 (1938), which held that mortgages secured by different underlying properties are not "substantially identical" for tax purposes.[6] The Tax Court specifically found that the mortgages exchanged by Petitioner were "materially different". The Fifth Circuit in *San Antonio* provides an excellent and detailed explanation of how mortgages could be materially different for tax purposes while substantially identical for regulatory accounting purposes as well as the weight to be given to the FHLBB's determination of substantial identity. *San Antonio*, *supra* at 591.

[5] Judge Cohen, in her concurring opinion in the Tax Court, held that the property exchanged by Petitioner did not have to be materially different in order to sustain a loss.

[6] Moreover, the holding that the exchanged mortgages were substantially identical in the present case was particularly unwarranted because the Tax Court did not rely solely on *Hanlin's* rule that mortgages with different underlying properties are not "substantially identical"; it went further and, based on the trial record, found as a matter of fact that the exchanged mortgages were likely to (and subsequently did) behave differently. Appendix at 37a.

The second finding of the Sixth Circuit is equally deficient. Under *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), the treatment of a transaction on a taxpayer's books does not control its tax treatment. Therefore, Petitioner's failure to record the loss on its books is irrelevant.

C. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORITIES UPON WHICH IT RELIES.

The Sixth Circuit's decision in this case relies heavily upon *Shoenberg* v. *Commissioner*, 77 F.2d 446 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935), and *Horne* v. *Commissioner*, 5 T.C. 250 (1945). This reliance is misplaced. Those cases involved transactions in which a taxpayer disposed of and reacquired the *same* property rights. Thus they are inapplicable to transactions (such as those at issue here) in which indisputably *different* properties were exchanged. Moreover, the results reached in both of those cases were supported by statutory non-recognition rules — the predecessor to Section 1091 in *Shoenberg*[7] and the predecessor to Section 1031 in *Horne*[8] — whereas no non-recognition rule is applicable to the transactions at issue here.

[7] The taxpayer in *Shoenberg* tried to avoid the wash-sale rule in section 118 of the Revenue Act of 1928 by having the stock he sold at a loss immediately repurchased by his controlled corporation, which then waited slightly more than 30 days to sell the stock back to him. The Eighth Circuit stated: "For all practical purposes, he used [his corporation] as an *agency* for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss." 77 F.2d at 449 (emphasis added). Under agency principles, the sale and repurchase fell within the statutory wash-sale rule, resulting in the disallowance of the losses at issue.

[8] The taxpayer in *Horne* purchased one certificate representing a "seat" on a stock exchange and sold another certificate to take a tax loss. The Tax

In addition, the Sixth Circuit improperly extended *Shoenberg's* rationale for denying a loss deduction, *viz.*, that the taxpayer is "no poorer than before the sale" because the identical stock was repurchased. 77 F.2d at 499. The taxpayer in *Shoenberg* was "no poorer" after the transactions because he ended up with the *exact same* property. However, the tax law cannot require — as the Sixth Circuit suggests — that taxpayers be poorer as the result of an exchange involving *different* properties in order for a loss to be deductible; if it did, taxpayers would be entitled to a deductible loss only in the event of a bad bargain. *See San Antonio*, 887 F.2d at 590 ("[r]ealization does not require that a taxpayer must be 'richer or poorer' as a *result of the exchange itself*" [original emphasis]).

The Sixth Circuit also misinterprets the "sham" and "substance-over-form" cases cited in its opinion (none of which is based on Section 165). *Keats* v. *United States*, 865 F.2d 86 (6th Cir. 1988), involved silver straddle transactions in which the taxpayer suffered no real economic losses; in contrast, it is undisputed that Petitioner suffered *real economic losses* on the mortgages exchanged in its transactions. In *Davis* v. *Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979), the court disregarded purported sales of apartment complexes to taxpayers by their wholly owned corporations, concluding the corporations had not in substance transferred the assets to the taxpayers; in contrast, it is undisputed that the subject mortgage participations were actually transferred to new owners by Petitioner. In *Owens* v. *Commissioner*, 568 F.2d 1233 (6th Cir. 1977), the court held that the purchase for cash of stock

Court held: "[T]he result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by section 112(b)(1) of the Internal Revenue Code [now Section 1031(a)(1)]." 5 T.C. at 256. See: *Perlin* v. *Commissioner*, 86 T.C. 388, 430 n.36 (1986) (characterizing *Horne* as a Section 1031 case).

in a shell corporation whose only asset was cash should be treated as an exchange of cash for cash, rather than a sale of the equity of a business; in contrast, it is undisputed that the assets exchanged by Petitioner were in fact different mortgages.

The case of *Widener Trusts* v. *Commissioner*, 80 T.C. 304 (1983), *acq*. 1984-1 C.B. 2, is instructive in the reciprocal sale area. In *Widener Trusts*, the Tax Court held that a reciprocal sale of stock between two trusts produced a deductible loss under Section 165 of the Code to each trust, despite each trust's admitted motive to realize tax losses to offset portfolio gains in the same year. *Id.* at 310. Further, the court found that even though both trusts had the same beneficiary, they were not related in a tax sense but were separate taxpayers, and that the sales had substance because each trust permanently terminated its ownership of the stocks sold and the income flow they produced. *Widener Trusts*, 80 T.C. at 313. Petitioner, like the taxpayer in *Widener Trusts*, entered into an arms-length transaction that resulted in a change in the flow of economic benefits. Just as in *Widener Trusts*, Section 165 should not prevent Petitioner's deduction of its losses.

D. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE.

The Sixth Circuit applies a standard that is tantamount to a non-statutory "wash-sale" rule within the framework of Section 165. The statutory wash-sale rule of Section 1091 denies loss deductions where a taxpayer sells or otherwise disposes of "stock or securities" and, within 30 days before or after such an event, acquires "substantially identical" stock or securities. Because mortgages are not stock or securities, Section 1091 cannot be applied in this case, and the Internal Revenue Service has not contended otherwise.[9] The Sixth Circuit's deci-

[9] The government conceded that none of the non-recognition sections of subtitle A of the Internal Revenue Code (which includes Section 1091) apply to this case.

sion effectively ignores Section 1091's limitation to stock or securities. This approach makes the statutory limitation meaningless, frustrating the clear intent of Congress and creates a judicially imposed nonstatutory wash-sale rule for mortgage transactions.

E. SECTION 165 DOES NOT PREVENT DEDUCTION OF PETITIONER'S LOSS.

Section 165 of the Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise. The Regulations refine this rule to provide that a loss must be evidenced by a closed and completed transaction, must be fixed by an identifiable event, and must be bona fide. Treas. Reg. Section 1.165-1(b) and (d). The Regulations further provide that in determining the existence of these factors, substance shall control and not form. Treas. Reg. Section 1.165-1(b). The Fifth Circuit in *San Antonio* concurred with the Tax Court's finding in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance.

The Fifth Circuit in *San Antonio* then stated that Section 165 and Treas. Reg. Section 1.165-1(b) simply do not apply to the facts of this case.

> The government's argument with reference to § 165 is a different facet of its previous argument that the loss sustained by SASA was not economically real. Even if it is conceded (as it was for summary judgment purposes) that there was no purpose for the R-49 transaction other than tax reduction, nevertheless SASA suffered a real economic reduction in the value of the mortgage participation interests it transferred and the economic reality of that loss was fixed by an identifiable event, an exchange of materially different items.

San Antonio, 887 F.2d at 592.

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Gregory* v. *Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd.* 293 U.S. 465 (1935). *See also Sullivan* v. *United States*, 618 F.2d 1001, 1007-1008 (3rd Cir. 1980) (which held that "there is nothing sinister in arranging one's affairs so as to minimize taxes.") Taxpayer in this case merely chose the time it wished to take its loss and minimize its taxes. Memorandum R-49 permitted taxpayer to do so by exchanging its mortgage loans for similar, but different loans and, at the same time, avoid recording the loss on its books.

Taxpayer sustained a real, economic loss, which loss was realized, recognized and should be allowed for income tax purposes. This Court should adopt the proper reasoning of the Fifth Circuit (and D.C. Circuit) and reject the reasoning of the Sixth Circuit Court of Appeals.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari be granted.

Respectfully submitted,

SCHWARTZ, MANES & RUBY

By: ______________________________
Dennis L. Manes

By: ______________________________
Scott M. Slovin

Attorneys for Petitioner
2900 Carew Tower
441 Vine Street
Cincinnati, Ohio 45202
(513) 579-1414

APPENDIX

No. 89-1036
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

COTTAGE SAVINGS ASSOCIATION,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

Decided and Filed December 4, 1989

Before: WELLFORD and NORRIS, Circuit Judges; and LIVELY, Senior Circuit Judge.

LIVELY, Senior Circuit Judge. This appeal requires us to decide whether a savings association is entitled to a loss deduction under the Internal Revenue Code[1] as a result of "reciprocal sales" of depreciated mortgage loans to other thrift institutions. The Commissioner of Internal Revenue disallowed the deductions and asserted deficiencies in corporate income tax for the years 1974 through 1980. Upon petition for redetermination of deficiencies, the Tax Court found that the petitioner, Cottage Savings Association, realized losses in the years under review and that the losses are

[1] As used in this opinion, "the Code" refers to the Internal Revenue Code of 1954, as amended.

recognized and deductible for income tax purposes. The Commissioner appeals, and we reverse.

I.

A.

One of the problems experienced by thrift institutions in recent years resulted from their historic practice of making long term mortgage loans at fixed interest rates. As interest rates rose in the late 1970s such institutions were caught in a cash squeeze. Their return from loans was low, but the current market required them to pay interest at higher and higher rates in order to attract new deposits. In addition, many savings institutions lost substantial amounts of deposits to higher-yielding money market funds and similar investment vehicles. Even though Cottage began offering adjustable rate mortgages in 1980, in common with other similar institutions, it continued to experience a drop in new loans and deposits.

The practice of generating losses by means of "reciprocal sales" resulted from a change in accounting requirements promulgated in 1980 by the Federal Home Loan Bank Board (FHLBB) as "Memorandum R-49." Prior to the issuance of R-49, the FHLBB's regulatory accounting principles required institutions to reduce their net worth by the amounts of any losses sustained in the sale of loans at less than book value. Under R-49, the institutions no longer were required to record such losses. By observing R-49's criteria, savings associations attempted to generate income tax refunds by entering into "reciprocal sales" transactions that produced deductible losses without impairing net worth. Based on "reciprocal sales" transactions with four other Ohio savings institutions on December 31, 1980, Cottage claimed losses on its 1980 corporate income tax return from sales of mortgage loans at less than book value. However, under R-49 it recorded no losses for accounting purposes. The resulting income tax refunds claimed for 1980 and carry-back years exceeded $677,000.

B.

R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical," and thus to qualify for special treatment. The sales must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms of maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms of maturity),
6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

All of the mortgage loans involved in Cottage's December 31, 1980, transactions satisfied the R-49 reqirements. These transactions consisted of the sale of 252 loans to the four reciprocating institutions and the purchase of 305 loans from the same associations. The institutions exchanged checks on December 31, with the purchaser paying the seller in each instance a discounted price for the loans, reflecting the difference between the then-current interest rate (14.863 percent) and the rates at which the loans had been made. The institutions did not actually sell whole loans; instead, they sold "90 percent participations" in each loan, with the seller re-

taining a 10 percent interest in each loan. The original lender continued to service the loans, with the borrowers making payments to that institution. Payments were then remitted to the purchasing association. It was stipulated that Cottage did not investigate the credit ratings of any of the borrowers on the loans it received in the transactions and did not inspect the real estate that secured the loans. The recording and tax treatment of the transactions were based on the single premise that the package of mortgage loans sold and purchased satisfied the criteria of R-49.

II.

A.

The government makes two basic arguments on appeal. First, it argues that the "reciprocal sales" were actually exchanges and that they did not satisfy the Code requirements for realization of loss upon the exchange of property. The government maintains that the Code and applicable Treasury Regulations treat a loss as realized only if the property exchanged is materially different. Since R-49 requires that the loans which are the subject of "reciprocal sales" be "substantially identical," they necessarily are not materially different.

Second, unless the "materially different" requirement is met, although a loss is "realized" in a reciprocal sales transaction, it is not deductible as a loss "sustained." No loss is sustained for income tax purposes if a transaction resulting in loss lacks economic substance. Since Cottage merely exchanged one pool of mortgage loans whose market value had fallen below their book value for a similar pool of loans, matched exactly as to interest rates and maturity dates, and reflected no loss for accounting purposes, there was no economic substance to the transaction.

B.

Cottage agrees that "realization" is the key issue in determining whether it is entitled to a loss deduction. According to Cottage, transfer of the mortgage loans resulted in a realized

loss regardless of whether the mortgage loans transferred and received materially differed from each other. While conceding that mere increase or decrease in the value of a taxpayer's property does not result in income or loss, Cottage contends that it is different when the increase or decease is "realized" in a completed transaction. When it results from an exchange rather than from a sale, a loss is realized, regardless of whether the properties exchanged are materially different.

While denying the existence of such a requirement, Cottage maintains that if exchanged properties must be materially different for a loss to be realized, that requirement was met in the December 31, 1989, transaction. The exchanged mortgages had different obligors and were secured by different parcels of real estate. They met R-49's "substantially identical" criteria respecting interest rates, maturities and similar features, but were nonetheless materially different because the presence of different obligors and different security meant that there were different risk factors.

Cottage argues that any realized loss is recognized for income tax purposes unless it falls within a statutory exception, and the "reciprocal sales" transactions do not fall within an exception.

Finally, Cottage argues that the transactions had economic substance. The mortgages had already suffered a decline in market value and this decline was converted into a realized loss by the transfer of the mortgages to a third party in a completed transaction. The fact that Cottage simultaneously purchased mortgage loans that satisfied the R-49 criteria from the transferees is irrelevant; the loss was realized, and it was recognized and deductible.

III.

A.

The Tax Court concluded that the transactions between Cottage and the four associations were exchanges, and that properties exchanged must be materially different for a loss to

be deductible. *Cottage Savings Association* v. *Commissioner*, 90 T.C. 372 (1988). A majority of the Tax Court applied Code section 1001(a) and Treas. Reg. 1.1001-1(a) in reaching this conclusion. Code section 1001 provides:

> § 1001. Determination of amount of and recognition of gain or loss
>
> (a) Computation of gain or loss
>
> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

26 U.S.C. § 1001(a)

The Tax Court also relied upon the opening sentence in Treas. Reg. 1.1001-1(a):

> § 1.1001-1 Computation of gain or loss.
>
> (a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

26 C.F.R. 1.1001-1(a). The remainder of subsection (a) deals exclusively with computation. Based on its conclusion that an exchange of properties produces a realized loss only if the properties are materially different and its determination that the mortgage loans involved in the December 31, 1980, transactions satisfied this requirement, the Tax Court majority held that Cottage's 1980 loss was recognizable and deductible.

Judge Cohen, joined by four other members of the Tax Court, concurred in the decision in *Cottage*, but reached her conclusion on a different basis. 90 T.C. at 403-04. She viewed Treas. Reg. 1.1001-1(a) as dealing with the computation of gain or loss rather than establishing a rule for determining whether gain or loss has been realized or recognized. Therefore, the reference in Treas. Reg. 1.1001-1(a) to "property differing materially either in kind or in extent" cannot be treated as creating a requirement for realization or recognition.

In her view, § 1001(c) controls the determination of whether gain or loss is recognized. That section provides:

> (c) Recognition of gain or loss
>
> Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

26 U.S.C. § 1001(c). Finding no provision to the contrary, Judge Cohen concluded that the exchange of pools of mortgage loans was an identifiable event that fixed the amount of loss, which § 1001(c) requires to be recognized.

B.

The Tax Court has applied the *Cottage* majority's reasoning in allowing the deduction of losses arising from "reciprocal sales" in subsequent cases. See *Federal National Mortgage Association* v. *Commissioner*, 90 T.C. 405 (1988), decided the same day as *Cottage*, *San Antonio Savings Association* v. *Commissioner*, T. C. Memo. 1988-204 (1988); *Leader Federal Savings and Loan Association of Memphis* v. *Commissioner*, T. C. Memo. 1989-321 (1989).

Two district courts in Texas have taken different approaches to the issue and have reached opposite conclusions. In *Centennial Savings Bank FSB* v. *United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), the court concluded that Treas. Reg. 1.1001-1(a) applied to a "reciprocal sale" transaction and interpreted the regulation as requiring that properties exchanged in the transaction be materially different before a loss will be realized. *Id.* at 1398. The court found, however, that mortgage loans matched under R-49 did not differ

materially and disallowed the deduction. Since Centennial did not consider individual differences in mortgage loans and the market place treated the mortgage pools alike, the individual differences lacked "economic relevance." *Id.* at 1399.

The district court also held that Centennial did not experience a real change in economic condition by reason of its R-49 transactions. Although its mortgages had declined in value, after the R-49 transaction, Centennial was no poorer than before. There had been no event that made the taxpayer "poorer to the extent of the loss claimed." *Id.* at 1400, quoting *Shoenberg* v. *Commissioner of Internal Revenue*, 77 F.2d 446, 449 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935). The loss was suffered as current interest rates drove down the market value of Centennial's mortgage loans; it did not occur when the discounted mortgage loans were exchanged with other associations for similar mortgage loans.

Reaching a different conclusion, the court allowed a loss deduction in *First Federal Savings and Loan Association of Temple* v. *United States*, 694 F.Supp. 230 (W.D. Tex. 1988). The court found that an R-49 transaction in which Temple transferred 360 mortgage loans to a Waco association and acquired 287 loans from that association was an exchange, even though structured as a "reciprocal sale." The exchange involved two pools of mortgage loans rather than individual loans. *Id.* at 236. The court found that Temple realized a loss under § 1001 because the transaction was an identifiable event that fixed the decline in value of the mortgages transferred. The decline in value was fixed as of the time of the R-49 transaction and it was immaterial that the taxpayer was in no worse economic position after the transfer than before. *Id.* at 239-42. The court found that the mortgages involved were not materially different, *id.* at 244, but concluded that this fact did not prevent the exchange from producing a realized loss. *Id.* at 242, 249.

The *Temple* court did not stop with its analysis of the realization requirement. It stated that recognition, not realization, was the critical issue. *Id.* at 232 n.2. It noted that

§ 1001(c) requires recognition of any gain or loss determined under § 1001(a) and (b) in the absence of a provision to the contrary. Treas. Reg. 1.1002-1 provides for strict construction of exceptions to the general rule requiring recognition of all gains and losses. There is no exception concerning nonrecognition of gains or losses from an exchange of loans, notes, or evidences of indebtedness. *Id.* at 247. Since no contrary provision applies to exchanges of mortgage loans, § 1001(c) is dispositive. *Id.* at 246.

Federal National Mortgage Association v. *Commissioner* is on appeal to the Court of Appeals for the District of Columbia and the two Texas cases have been appealed to the Fifth Circuit Court of Appeals. Neither court has rendered a decision at the time of preparation of this opinion.

IV.

A.

Our approach to this case differs from that of the other courts that have considered the issue. We agree with Judge Cohen that § 1001(a) deals only with the computation of the amount of gain or loss, not whether a gain or loss is realized. Further, it does not prescribe a rule for determining whether a gain or loss will be recognized. That determination is controlled by § 1001(c), the recognition provision. In our view, the inquiry does not stop with a determination that a loss is recognizable; it must also be deductible under § 165, which deals comprehensively with the income tax treatment of losses. Section 165(a) provides:

> **(a) General Rule.** There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

26 U.S.C. § 165(a). Read together, §§ 1001(c) and 165(a) appear to provide that any recognizable loss sustained during a taxable year is deductible unless otherwise compensated. The nature of the loss allowed is set forth in Treas. Reg. 1.165-1(b):

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance, and not mere form shall govern in determining a deductible loss.

26 C.F.R. § 1.165-1(b).

We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event — the "reciprocal sales" transaction. Since there is no Code exception that applies, under § 1001(c) the loss must be recognized. The remaining question is whether an actual loss was sustained for income tax purposes so as to be deductible under § 165.

B.

It is clear that a taxpayer's motive in entering into a transaction resulting in a loss does not control deductibilty. A taxpayer may reduce the amount of tax otherwise due, or avoid it altogether, "by [any] means which the law permits." *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935). What is done for the purpose of tax avoidance must, however, have some business purpose and not be an economic transaction in form only. The courts will not "exalt artifice above realty." *Id.* at 470.

Shortly after the Supreme Court decided *Gregory*, the Eighth Circuit Court of Appeals applied the teachings of *Gregory* in a case involving the sale and purchase of corporate stocks. In *Shoenberg* v. *Commissioner of Internal Revenue*, 77 F.2d 446 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935), the taxpayer devised a plan involving related but separate transactions in order to avoid the "wash sale" provision of the Code. Under § 1091, a loss on the sale of shares of stock or

other securities may not be deducted where the seller acquires substantially identical stock or securities within 30 days before or after the sale. 26 U.S.C. § 1091. The purpose of this provision is to prevent deductions for fictitious losses and to require that there be a change in the economic position of the taxpayer. *Hanlin* v. *Commissioner of Internal Revenue*, 108 F.2d 429, 430 (3d Cir. 1939).

The taxpayer in *Shoenberg* sold individually owned corporate stocks through a broker on December 5, 1930. The same day the broker purchased equal shares of the identical stocks for the same prices in the name of an investment company controlled by the taxpayer. Slightly more than 30 days thereafter the taxpayer purchased the stocks from the investment company at the current market price, slightly below the price at which he had sold them through the broker. The taxpayer claimed a loss on his 1930 income tax return based on the December 5 sale of the stocks at prices below his tax basis. The court agreed with the taxpayer that there was an actual sale. This satisfied the requirement that the loss be "realized" by some completed "identifiable event." *Id.* at 448. However, the court concluded that it could look beyond the form to the substance of the entire transaction. In denying the deduction, the court stated:

> To secure a deduction, the statute requires that an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed; in other words, he has that much less than before.
>
> A loss as to particular property is usually realized by a sale thereof for less than it cost. However, where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and substantial; it is not real. This is true because the taxpayer has not actually changed his position and is no poorer than before, the sale. The particular sale may be real, but the entire transaction prevents the loss from being actually

suffered. Taxation is concerned with realities, and no loss is deductible which is not real.

Id. at 449.

The Tax Court employed similar reasoning in *Horne* v. *Commissioner of Internal Revenue,* 5 T.C. 250 (1945). Although the property sold and bought — a seat on a commodities exchange — was not covered by the "wash sale" provision of the Code, the court disallowed a claimed deduction. The court stated:

> Underlying all of the loss deduction provisions of the statute is the concept of a financial detriment actually suffered by the taxpayer. Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense.

Id. at 254.

In determining the tax consequences of a transaction, this court considers substance over form and examines the total context of the transaction. In *Johnson* v. *Commissioner of Internal Revenue,* 495 F.2d 1079 (6th Cir.), *cert. denied,* 419 U.S. 1040 (1974), the taxpayers were held liable for capital gain taxes as the result of a series of transactions. The taxpayers transferred appreciated but encumbered stocks to a trust, which in turn assumed the debt secured by the stocks. After noting that tax liability is determined by the substance rather than the form of a transaction, the court stated:

> When one overall transaction transferring property is carried out through a series of closely related steps, courts have looked to the essential nature of the transaction rather than to each separate step to determine tax consequences of the transfer.

Id. at 1082.

This court has consistently disallowed loss deductions based on transactions in which the taxpayer's economic position was

not changed for the worse. In *Owens* v. *Commissioner of Internal Revenue,* 568 F.2d 1233 (6th Cir. 1977), Judge Peck wrote for the court:

> What the law does not permit a taxpayer to do in seeking to avoid taxes is to cast transactions in forms when there is no economic reality behind the use of the forms. "The incidence of taxation depends upon the substance of a transaction. . . . To permit the true nature of a transaction to be disguised by mere formalism, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner of Internal Revenue* v. *Court Holding Co.,* 324 U.S. 331, 334, 65 S. Ct. 707, 708, 89 L.Ed. 981 (1945). See *Gregory* v. *Helvering, supra,* 293 U.S. 465, 55 S. Ct. 266, 79 L.Ed. 596; *Union Planters National Bank* v. *United States,* 426 F.2d 115, 117 (6th Cir.), *cert. denied,* 400 U.S. 827, 91 S. Ct. 53, 27 L.Ed.2d 56 (1970).

Id. at 1237. Judge Peck further bolstered his conclusion that an attempted pass-through of deductions generated by a "Subchapter S" corporation did not produce deductible losses for the taxpayer by quoting one of Judge Learned Hand's trenchant dissents:

> "The Income Tax imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for *we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.*" (Emphasis supplied.)
>
> *Gilbert* v. *Commissioner of Internal Revenue,* 248 F.2d 399, 410, 411 (2d Cir. 1957)(Hand, J., dissenting.).

Id. at 1240.

The court reached the same result in *Davis* v. *Commissioner of Internal Revenue*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979), where a transaction that appeared to produce realized losses was found to be a sham. More recently this court agreed with the Commissioner that a series of "straddle" transactions in silver from which a taxpayer claimed losses were shams. The loss deduction was disallowed because the transactions had no economic substance beyond producing tax losses. *Keats* v. *United States*, 865 F.2d 86 (6th Cir. 1988). Citing *Gregory*, *Davis*, and *Owens*, the *Keats* court found two settled rules respecting claims for deduction of losses: "(1) that claimed deductions may properly be disallowed by the IRS even though the relevant transactions actually occurred as represented by the taxpayer, and (2) that non-tax economic substance must inhere in the relevant transactions before loss deductions will be allowed." *Id.* at 88.

CONCLUSION

We agree with the *Centennial* court that a savings institution is not entitled to deduct losses from the sale of a pool of mortgage loans at prices below book value when the transaction is part of a "reciprocal sale" under which the institution acquires a pool of substantially identical mortgage loans. We do not agree with *Centennial*, however, that the determining factor is the lack of a material difference in the properties sold and purchased. In form, Cottage's "reciprocal sales" produced an identifiable event that fixed the amount of decline in the value of the mortgage loans that it transferred. Because Cottage received a substantially identical pool of mortgages in exchange, however, and did not record the decline on its books, it was not "poorer to the extent of th loss claimed." *Shoenberg*, 77 F.2d at 449. When the entire transaction is considered, it is clear that Cottage's economic position was not changed by the "reciprocal sales." Under these cir-

cumstances, there can be no deduction because no loss has been sustained. A loss is deductible only if specifically authorized by the Code, and § 165 limits deductibility to losses actually sustained.

The petition for review is granted, and the decision of the Tax Court is reversed.

90 T. C. No. 28

UNITED STATES TAX COURT

COTTAGE SAVINGS ASSOCIATION,
Petitoner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 27487-83.
Filed March 14, 1988.

Petitioner, a regulated savings and loan institution, entered into reciprocal sales and purchases of loan participations with four other unrelated savings and loan institutions. These transfers were at then-current fair market values, substantially below petitioner's bases in the loans. Although the transfers were bona fide, they were made solely to produce losses for Federal income tax purposes, in amounts great enough to result in net operating loss carrybacks which generated substantial Federal income tax refunds. Pursuant to a ruling of the Federal Home Loan Bank Board (Memorandum R-49), petitioner did not recognize the claimed losses for regulatory accounting purposes.

Held: Petitioner realized losses on the transfers; these losses are recognized for Federal income tax purposes and are deductible. Secs. 1001, 165, I.R.C. 1954.

Dennis L. Manes, *Scott M. Slovin*, and *Richard M. Schwartz*, for the petitioner.*

* Briefs amici curiae were filed by Richard L. Bacon and Thomas A. Pfeiler (as attorneys for the United States League of Savings Institutions), by Robert W. Minor, George N. Corey, and Aaron Rosenfeld (as attorneys for the Ohio Savings & Loan League), and by Martin S. Schwartz and Aaron M. Peck (as attorneys for the California League of Savings Institutions).

Joseph R. Goeke and *Mary Helen Weber*, for the respondent.

CHABOT, *Judge:* Respondent determined deficiencies in Federal corporate income tax against petitioner for 1974 through 1980, as follows:

Year	Deficiency
1974	$ 47,029.09
1975	62,889.23
1976	102,014.57
1977	154,520.26
1978	185,427.59
1979	54,187.23
1980	73,752.53

After a concession by petitioner,[1] the issue for decision[2] is whether petitioner realized recognizable losses from sales of 90-percent particip ons in loan portfolios to other savings and loan institutions, from which petitioner simultaneously acquired 90-percent participations of approximately equal aggregate value and, if so, whether petitioner may deduct those losses.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner's principal place of business was in Cincinnati, Ohio.

[1] By a stipulation filed on December 29, 1986, an adjustment relating to dividends on withdrawable savings has been conceded by petitioner; the concession may be withdrawn if, before we file our opinion in the instant case, the Court of Appeals for the Seventh Circuit has rendered an opinion reversing our decision in *Colonial Savings Association* v. *Commissioner*, 85 T.C. 855 (1985).

[2] The notice of deficiency adjustments relating to bad debts and charitable contributions are derivative and depend on the resolution of the issue for decision.

Background

Since 1883, petitioner has been in the business of receiving savings deposits from the public and in turn making loans secured by residential and commercial real estate. Petitioner profited by making loans from deposits at interest rates higher than petitioner paid to depositors, and from charging points for the origination of such loans. Petitioner, a State-chartered mutual savings association, was a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes refered to as "the FHLBB"). Petitioner was required to file semiannual financial reports to the FHLBB reporting petitioner's financial condition in conformity with accounting principles adopted by the FHLBB and commonly referred to as regulatory accounting principles (hereinafter sometimes referred to as "RAP").

For 1980 and all the other years in issue (see n. 6, *infra*), petitioner filed its income tax returns on a calendar-year basis and used the accrual method of accounting for all purposes.

In 1980, savings and loan deposits were declining because funds were being diverted to higher-yielding money market funds. Earnings of savings and loan institutions declined as interest paid on deposits exceeded the interest earned on loan portfolios. In addition, because of the increases in market interest rates, the market values of existing fixed-interest loan portfolios held by savings and loan institutions were substantially less than the book values of these loan portfolios.

In 1980, petitioner began to offer adjustable-rate mortgages, which would allow interest rates to be adjusted to meet changes in the market. The number and dollar volume of loans made by petitioner dropped, however. Petitioner experienced a shortage of funds because of the loss of deposits to money market mutual funds and because high interest rates charged by the FHLBB eliminated the FHLBB as a source of funds that petitioner could use to make profitable loans. Petitioner expected the decline in deposits to continue.

FHLBB regulations required petitioner (and other federally

insured savings and loan institutions) to meet certain net worth requirements. These requirements were revised by amendments published on November 6, 1980, with an effective date of November 17, 1980.

If petitioner had sold the loan participations described *infra*, and had been required by the FHLBB's RAP to reduce its net worth by the amounts of the losses that it would have sustained (in table 4, *infra*, compare the last two columns; in table 5, *infra*, compare column (3) with column (4)), then petitioner's net worth would have been reduced to such a level that it would barely exceed the FHLBB's mimimum requirements.

Memorandum R-49

On June 27, 1980, the Director of the Office of Examination and Supervision (OES) of the FHLBB issued Memorandum R-49 relating to "reciprocal sales" of mortgage loans, with the following stated synopsis: "A LOSS NEED NOT BE RECORDED FROM 'RECIPROCAL SALES' OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS". The body of Memorandum R-49 states as follows:

> The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.
>
> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded [under RAP]. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g., 30 years),

4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggegate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal amount of those originally sold, the purchaser should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to loss on sale of mortgage loans.

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry to structure exchanges of mortgage loans to create losses for income tax reporting purposes which would not be reported under RAP or under generally accepted accounting principles (hereinafter sometimes referred to as "GAAP").

The criteria selected in Memorandum R-49 represented an attempt by the FHLBB, OES, to maintain the regulated institution's position with respect to three types of risk in a loan portfolio. These risks related to credit or collectibility, rate or future earnings potential, and repayment or extent of principal repayments and prepayments. In the opinion of the OES, a change in any of these risks would change the economic factors underlying a savings and loan institution's loan portfolio and, as a result, require recording the resulting gain or loss under RAP.

A memorandum dated August 10, 1981, from the Director of the OES to the Executive Staff Director of the FHLBB, sets forth the following explanation with respect to the criteria listed in Memorandum R-49.

> When developing the criteria contained in Memorandum R-49, we worked closely with the AICPA Committee on Savings and Loan Associations. In addition to communication with this committee, we also obtained agreement with our stance from prominent CPAs serving the industry. * * * Our objective at that time was to structure a transaction which was as close as possible to the IRS "materially different" definition which would still not change the economic position of the association after it engaged in the swap. It was and remains our opinion that Memorandum R-49 represents a transaction which is on a fine line between "substantially identical" and "materially different".
>
> These criteria represented our attempt to maintain the association's position with respect to the three types of risks in a loan portfolio. These risks relate to credit (collectibility), rate (future earnings potential), and repayment (extent of principal repayments and prepayments). In our opinion, a change in any of these risks would change the economic factors underlying an association's loan portfolio and, as a result, require recording the resulting gain or loss.

The following schedule relates the ten criteria for non-recognition, as outlined in Memorandum R-49, to these types of risks.

Criteria	Risk		
	Credit	Rate	Repayment
1) involve only single family residential mortgages	X		X
2) are similar type (conventional vs insured)	X		X
3) same stated terms to maturity (i.e. 29 yrs.)			X
4) identical stated interest rates		X	X
5) similar seasoning			X
6) aggregate principal amounts within 2½% or $100,000, with difference made up in cash	X	X	X
7) sold without recourse	X		
8) similar fair market values	X	X	X
9) similar loan to value ratio at time of maturity	X		
10) security properties in same state			X

These criteria vary in importance and effect in achieving the desired objective (i.e. assuring that risk does not transfer). However, it is OES's opinion that all are necessary in their present form to structure the transaction which does not trigger a loss under GAAP.

Transactions in Issue

Before and during 1980, the independent accounting firm engaged by petitioner was Frank Milostan and Associates

(hereinafter sometimes referred to as "Associates").[3] In October, 1980, Frank Milostan (hereinafter sometimes referred to as "Milostan") of Associates attended a week-long seminar given by an accounting firm in Houston, Texas. This seminar concerned the banking and savings and loan industries. At this seminar, Milostan was introduced to the concept of reciprocal loan sales. On his return to Cincinnati, Milostan asked the staff of Associates to consider the benefits of such a concept to Associates' clients.

On November 6, 1980, Associates gave a seminar in which the speakers highlighted the use of reciprocal sales to obtain refunds of Federal income taxes. The registration form mailed to Associates' clients and to the other savings and loan institutions which were invited to the seminar captioned the seminar "*1980 TAX STRATEGIES FOR FINANCIAL INSTITUTIONS* (Your Contribution to the National Debt!!)". Petitioner's president, William C. Kordis (hereinafter sometimes referred to as "Kordis"), was invited to attend on behalf of petitioner, and he and at least one other officer of petitioner attended the seminar.

Before attending the seminar, Kordis had discussed with Milostan the possibility of reciprocal sales of mortgage loans as a method of obtaining cash flow resulting from tax refunds. After the seminar, Kordis discussed with petitioner's board of directors the possibility of entering into such transactions, and invited Milostan to come and explain the possibility in more depth to the board of directors. On November 10, 1980, Milostan and Stanley Quay (an associate of Milostan) discussed reciprocal sale transactions with petitioner's board of directors, and on that date the board of directors passed the following resolution to enter into such transactions:

> RESOLVED: To enter into reciprocal sales of mortgage loans to other non-related financial institutions in ex-

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[3] Associates did the legally required audit work for petitioner. Associates also prepared petitioner's tax returns and provided petitioner with consulting services and advice as to improving petitioner's profitability.

change for mortgage loans of identical interest rates, stated maturities and seasoning. The reciprocal sale of mortgage loans will not result in a gain or loss for finfncial [sic] reporting purposes. (R-49) However, the reciprocal sale of mortgage loans will result in an ordinary loss for Federal Income Tax purposes equal to the difference between the book value of the portfolio sold and the fair market value of the portfolio purchased on the date of sale. (Revenue Ruling 71-558)

On December 31, 1980, petitioner as "Seller" entered into a series of Loan Participation Sale and Trust Agreements as shown in table 1.

Table 1

Buyer	No. of Loans	Total Consideration
Rosemont Savings Assoc.	8	$ 99,388.66
Civic Savings Assoc.	44	655,575.72
First Financial Savings Assoc.	188	3,432,714.35
Kenwood Savings and Loan Assoc.	12	271,176.09

Also on December 31, 1980, petitioner as "Buyer" entered into a series of Loan Participation Sale and Trust Agreements as shown in table 2.

Table 2

Seller	No. of Loans	Total Consideration
Rosemont Savings Assoc.	8	$ 98,257.50
Civic Savings Assoc.	45	655,488.29
First Financial Savings Assoc.	240	3,431,868.28
Kenwood Savings and Loan Assoc.	12	271,298.43

Rosemont Savings Association, First Financial Savings Association, and Kenwood Savings and Loan Association are Ohio corporations located in Cincinnati, Ohio. Civic Savings Association is an Ohio corporation with its principal offices in Portsmouth, Ohio. (These four associations are hereinafter sometimes collectively referred to as "petitioner's trading partners".)

Each of petitioner's trading partners was unrelated to petitioner, was run by other people, and had a board of directors that was separate from that of any of the other of petitioner's trading partners.

In each of the transactions described in table 1 or table 2, *supra* (hereinafter sometimes referred to as "the December 31, 1980, transactions"), the "Buyer" delivered to the "Seller" a check for the total consideration stated in the applicable agreement. Checks were thus exchanged on December 31, 1980, as shown in table 3.

Table 3

Savings and Loan Institution	Amount Paid to Petitioner	Amount Paid by Petitioner
Rosemont Savings Assoc.	$ 99,388.66	$ 98,257.50
Civic Savings Assoc.	655,575.72	655,488.29
First Financial Savings Assoc.	3,432,714.35	3,431,868.28
Kenwood Savings and Loan Assoc.	271,176.09	271,298.43
Total	$4,458,854.82	$4,456,912.50

No other cash payments were made between petitioner and petitioner's trading partners as consideration for the reciprocal sales.

Each of the December 31, 1980, transactions was at then-current fair market values. The then-current interest rate used in computing these fair market values was 14.863 percent. The loans, participations in which were sold by petitioner, had declined in value before the sales.

Table 4 presents information about the loans that were the subjects of the 90-percent participation transfers from petitioner to Civic Savings Association.

Table 4

No. of Loans	Int. Rate %	Orig. Term Yrs.	Average Inception Date	Remaining Loan Bal. as of 12/24/80	Market Value
1	7.5	25	8/30/72	$ 26,393.86	$ 17,101.75
2	8.0	20	7/30/73	22,227.65	15,945.98
1	8.25	20	7/30/73	8,714.76	6,334.47
1	8.5	25	5/31/76	17,739.61	11,728.76
2	8.5	25	2/29/77*	84,449.97	55,398.77
2	8.5	30	4/30/77	65,259.06	40,960.32
1	8.75	20	5/31/76	35,353.74	25,267.99
3	8.75	20	10/31/76	61,933.13	44,012.84
3	8.75	20	9/30/77	53,074.67	37,265.73
2	8.75	25	6/30/74	26,755.85	18,392.94
2	8.75	25	7/31/75	32,339.03	21,966.89
2	8.75	25	6/30/76	44,398.86	29,874.55
1	8.75	25	1/31/77	18,876.01	12,628.47
6	8.75	25	9/30/77	176,795.31	117,539.59
1	8.75	30	7/31/75	34,220.30	22,217.99
2	8.75	30	9/30/76	67,060.24	43,172.54
2	8.75	30	8/31/77	93,705.71	59,955.09
1	9.0	20	5/31/75	9,820.84	7,222.76
1	9.0	20	4/30/76	11,589.66	8,417.92
1	9.0	20	10/31/77	25,725.41	18,334.46
3	9.0	20	4/31/78	59,402.73	42,086.14
4	9.0	25	3/31/78	107,597.53	72,591.52
44				$1,083,429.93	$728,417.47
90% participations				$ 975,086.94	$655,575.72

Table 5 shows, by buyer, the aggregate remaining loan balances of the loans participations in which were transferred

* So indicated in the stipulated exhibit.

by petitioner, 90 percent of these aggregate balances, the amount the buyer paid to petitioner, and the relationship of the amount paid to the loan balance transferred.

Table 5

(1) Buyer	(2) Remaining Loan Bal. as of 12/31/80	(3) 90%	(4) Amount Paid to Petitioner	(5) Column (4) as % of Column (3)
Rosemont Sav. Assoc.	$ 162,326.47	$ 146,093.82	$ 99,388.66	68.03
Civic Sav. Assoc.	1,083,429.93	975,086.94	655,575.72	67.23
First Fin. Sav. Assoc.	5,963,676.47	5,367,308.82	3,432,714.35	63.96
Kenwood S. & L. Assoc.	465,242.23	418,718.01	271,176.09	64.76
Totals	$7,674,675.10	$6,907,207.59	$4,458,854.82	64.55

Each of the loan participation sale and trust agreements entered into by petitioner on December 31, 1980, states "Seller hereby sells and issues to buyer * * * a 90% participation ownership (subject to the terms and conditions of said Participation Agreement) in loans described in the list * * * attached hereto * * *." The subject loans were described in packages by interest rate, total term, and term to maturity. The packages which were subject to the agreements were matched under the criteria of FHLBB Memorandum R-49.

As a result of the December 31, 1980, transactions, petitioner was required to undertake additional administrative activity. Petitioner continued to service the loans in which it had sold the participations. Monthly reports of the transferred loan participations were prepared by each of the transferor institutions for each of the transferee institutions. In addition, payments on the participations were made monthly. Petitioner also had to record and maintain record relative to the payments on the participation packages received from petitioner's trading partners.

Petitioner and Associates considered it advantageous to sell 90-percent participation interests in the loans rather than selling the loans outright. Petitioner thus was able to maintain its

relationship with the obligors on the loans, since these obligors were not aware that participation interests in their loans had been transferred. In addition, petitioner was not required to transfer the records associated with the mortgages to the buyers of the participation interests.

In entering into the December 31, 1980, transactions, petitioner relied on its officers' knowledge of the trustworthiness of the individuals from petitioner's trading partners and the assumed increase in value of the collateral from the date of the loans. In selecting the loans for inclusion, petitioner and petitioner's trading partners did not investigate individual loan files, employment histories of the individual borrowers, or the underlying value of the real estate securing the individual loans. Only current, i.e., nondelinquent, loans were considered.

The participations sold and bought by petitioner all were in loans that had different obligors, that were "conventional" loans secured by mortgages on single-family residential properties, and that were current as of December 31, 1980. The underlying security for each loan was different, in that each property had a different location. Most of the properties are inside the Cincinnati "beltway" (U.S. highway I-275).[4] Most of the in-beltway properties where petitioner was the seller are east of downtown Cincinnati, while the in-beltway properties where petitioner was the buyer are more evenly distributed throughout the area. Some of the properties where petitioner was the buyer are as far north as Dayton, Ohio (about 55 miles from Cincinnati), and some are as far east as Jackson, Ohio (about 120 miles from Cincinnati). Of the properties where petitioner was the seller, some are as far north as Middletown, Ohio (about 35 miles from Cincinnati), and some are as far east as Batavia, Ohio (about 25 miles from Cincinnati).

[4] Portions of Indiana and Kentucky are inside the Cincinnati beltway, but all of the properties are in Ohio. See Memorandum R-49, item 10, *supra*.

Sales or purchases of participations, such as the 90-percent participations involved in this case, are customary; and loans that are sold or purchased are usually sold or purchased in a group by savings and loan institutions. Reciprocal sales of loans by savings institutions occurred before the December 31, 1980, transactions. Although diversification by geography and other factors may be reasons for reciprocal sales transactions generally, such factors were not considered in the December 31, 1980, transactions.

In the savings and loan industry, it is recognized that, generally, mortgage loans do not run to the completion of the terms of the loans. Petitioner made no attempt to determine, on a loan-by-loan basis or an aggregate basis, whether there was a difference between the prepayment potential or anticipated income stream of the loan participations received by petitioner and those transferred by petitioner on December 31, 1980. Actual collections did not achieve the equality anticipated at the time of the transfers.

Table 6 shows the actual payments that were made on account of the loan participations that petitioner sold and the loan participations that petitioner bought in the December 31, 1980, transactions.

Table 6

A. Payments on Participations that Petitioner Sold

Year	Principal	Interest	Total
1980 (Dec.)	$ 34,701.50	$ 21,382.87	$ 56,084.37
1981	257,800.81	555,555.62	813,356.43
1982	436,363.54	535,448.10	971,811.64
1983	535,229.54	488,253.91	1,023,483.45
1984	531,543.80	448,783.87	980,327.67
1985 (thru March 31)	118,122.04	99,045.58	217,167.62
Totals	$1,913,761.23	$2,148,469.95	$4,062,231.18

B. Payments on Participations that Petitioner Bought

Year	Principal	Interest	Total
1980 (Dec.)	$ 4,915.60	$ 10,307.45	$ 15,223.05
1981	340,987.22	551,244.92	892,232.14
1982	366,480.57	530,205.40	896,685.97
1983	545,186.08	483,669.37	1,028,855.45
1984	437,770.45	446,202.40	883,972.85
1985 (thru March 31)	46,956.78	106,916.30	153,873.08
Totals	$1,742,296.70	$2,128,545.84	$3,870,842.54

Participation interests are less liquid than whole loans in the secondary market. That is, there is an active secondary market for mortgage loans but very little market for participation interests. As a result, after the December 31, 1980, transactions, petitioner and its trading partners all were in a less liquid position (except for their income tax refunds) than they had been before the December 31, 1980, transactions.

The December 31, 1980, transactions met the criteria of Memorandum R-49 of the FHLBB and qualified for nonrecognition of loss under RAP. Petitioner did not report under RAP any losses on the December 31, 1980, transactions.[5]

* * * *

The December 31, 1980, transactions were between independent parties; the transactions were closed and completed; the transactions were bona fide. At the time of the transactions, petitioner and its trading partners anticipated that the income stream earned from the loan participations that were acquired would be substantially equal to the income stream earned from the loan participations that were sold. If this anticipated equality did not occur, absent misrepresentations, the party receiving less in actual collections had no recourse against the party receiving more.

[5] In the notice of deficiency, respondent allowed bad debt loss deductions on some of the loans that petitioner had sold participations in, as part of the December 31, 1980, transactions. The computation of the loss claimed by petitioner on the reciprocal sales transactions is not in dispute.

Before the December 31, 1980, transactions, petitioner's loan portfolio had decreased in market value because of economic conditions general to the savings and loan industry. The losses claimed by petitioner accurately reflect the decrease in petitioner's assets from book value to market value.

The December 31, 1980, transactions were motivated solely by the desire of petitioner and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios each institution owned before the December 31, 1980, transactions.

OPINION

Respondent contends that the December 31, 1980, transactions were exchanges, and not independent purchases and sales; that, in order for gain or loss to be recognized on these transactions, the gain or loss must be realized; that there was no realization of gain or loss under section 1001[6] because the property that petitioner gave was not materially different from what petitioner received; and that petitioner's claimed losses lack substance and are not allowable under section 165(a) because the transfers were solely tax-motivated and resulted in no significant change in petitioner's economic position. Respondent concedes that petitioner's claimed losses on the sales of the loan participations would have been realized, recognized, and deductible but for petitioner's simultaneous acquisition of the loan participations, as shown in tables 1 and 2, *supra*.

Petitioner maintains that the December 31, 1980, transac-

[6] Unless otherwise indicated, all section and subtitle references are to sections and subtitles of the Internal Revenue Code of 1954 as in effect for 1980. The instant case involves 1974 through 1979 because the December 31, 1980, transactions, if given their claimed tax effect, produce net operating losses that are properly carried back to each of the earlier years. Petitioner filed a claim for tentative refunds and the tentative refunds were paid. Thus, although the dispute before us affects petitioner's tax liabilities for each year in the 7-year period, the resolution of the dispute depends entirely on the treatment of the December 31, 1980, transactions.

tions were sales and not exchanges; that the nonrecognition provisions in section 1.1001-1(a), Income Tax Regs., are "inapplicable and * * * overridden by the other provisions in the Regulations and the Internal Revenue Code"; that even if the regulation applies, the mortgage loans with different obligors are not substantially similar and they differ materially in kind or extent; that the treatment of the December 31, 1980, transactions for purposes of GAAP and RAP has no effect on tax treatment; and that the transfers "were for a valid economic purpose".

We agree with respondent that the December 31, 1980, transactions were exchanges, and not independent purchases and sales; that these transactions were solely tax-motivated and had no business purpose other than to secure refunds of previously paid taxes by generating substantial net operating loss carrybacks; and that, in order for a gain or loss to be recognized, the gain or loss must be realized. We agree with petitioner that it realized the claimed losses on these transactions, that these losses are recognizable, and that these losses are deductible.

Sales v. Exchanges

As a preliminary matter, we reject petitioner's contentions that the four pairs of transactions occurring on December 31, 1980, were not reciprocal and cannot be regarded as "exchanges" as distinguishable from "sales". Petitioner argues that the loan sales transactions occurred between petitioner, on the one hand, and four other savings and loan institutions, on the other, solely as a matter of expediency. Petitioner denies that the transactions were reciprocal, interdependent, or conditioned on one another, and points out that the agreements do not expressly make them interdependent.

The obvious and expressed intention of the contracting parties was to come within the terms of Memorandum R-49. That Memorandum specifically referred to "reciprocal sales of substantially identical mortgage loans". The testimony at trial, including that of Kordis, referred to the transactions as reciprocal. Kordis testified that, but for the deposit of checks

from petitioner's trading partners in the December 31, 1980, transactions (see table 3, *supra*), petitioner "probably" would have had to borrow funds in order to be sure that its checks would be honored. Milostan further described the December 31, 1980, transactions as interdependent. Petitioner did not object to respondent's proposed finding, adopted by us *supra*, that Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry *to structure exchanges of mortgage loans* to create losses for income tax reporting purposes. Petitioner's counsel conceded, in his opening statement at trial, that petitioner bought about as much as it sold, "in order to comply with the regulatory accounting principle known as R-49, which required that loans be purchased in order not to recognize the loss [for] financial accounting purposes which, in most instances, if it had to be recognized, would have brought these savings and loans beneath the net worth requirements of the Federal Home Loan Bank." The only practical interpretation of the simultaneous purchases and sales were that they were interdependent in order to avoid the necessity of reporting losses under GAAP or RAP. Under these circumstances, the separate agreements will be regarded together as an overall transaction rather than as separate sales between the contracting parties. See *Johnson* v. *Commissioner*, 495 F.2d 1079, 1082 (CA6 1974), affg. 59 T.C. 791, 807-808 (1973); *Estate of Schneider* v. *Commissioner*, 88 T.C. 906, 938-942 (1987), on appeal (CA7, Oct. 6, 1987); *Monson* v. *Commissioner*, 79 T.C. 827, 834-837 (1982); *Smith* v. *Commissioner*, 78 T.C. 350, 380-381 (1982). Thus, we have adopted, for purposes of our opinion, respondent's characterization of the transactions as exchanges.

However, this conclusion does not resolve the case before us; it merely sets the framework for the remainder of our analysis. See *Monson* v. *Commissioner*, *supra; Smith* v. *Commissioner*, 78 TC. at 385-390.

Basic Analysis

Under section 1001,[7] if there has been a sale or other disposition of property and the taxpayer's basis exceeds the amount realized, then the resulting loss is to be recognized unless subtitle A provides otherwise. Respondent does not contend that any nonrecognition provision in subtitle A applies to the transfers of the mortgage loan participations in dispute in the instant case (except to the extent that section 1001 may be viewed as a nonrecognition provision). Under section 165(a),[8] the losses are deductible for 1980 (see n. 6, *supra*) if they were sustained during 1980.

On December 31, 1980, petitioner simultaneously bought and sold 90-percent participations in residential mortgage

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[7] Section 1001 provides, in pertinent part, as follows:

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss. — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section and for determining loss over the amount realized.

(b) Amount realized. — The amount realized from the sale or other dispostion of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized —

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of Gain or Loss. — Except as otherwise provided in this subtitle [subtitle A, relating to income taxes], the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

[8] SEC. 165. LOSSES.

(a) General Rule. — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

loans. The transfers were at then-current fair market values which, in the case of the participations that petitioner sold, were substantially below petitioner's cost bases. (See table 5, *supra*.) The loans that were affected were carefully selected by petitioner and by petitioner's trading partners to satisfy the equivalence criteria set forth in FHLBB Memorandum R-49, and also to match as nearly as practicable the aggregate fair market values of the loan participations transferred in the opposite direction. See tables 1, 2, and 3, *supra*. The transfers were bona fide, completed transactions. That is, petitioner assumed all the benefits and burdens of the loan participatoins it acquired and petitioner's trading partners assumed all the benefits and burdens of the loan participations they acquired from petitioner.

The transfers were solely tax-motivated. That is, although participations often are sold for a variety of business reasons, in the instant case the loan participation sales and offsetting purchases were effectuated solely to reduce petitioner's tax liabilities (and, presumably, the tax liabilities of petitioner's trading partners).[9] This, by itself, is not fatal to petitioner's

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[9] Petitioner contends that there were other reasons, specifically geographic diversification, improving relations with other institutions, increasing its servicing portfolio, and the possibility of faster payoffs. The record would not support a finding that any of these possible concerns played any part in the transactions of December 31, 1980. In fact, the record supports a finding that they did not, and we have so found. Petitioner also states that "Milostan stated in his testimony that another reason to sell and repurchase loans was to reinvest the proceeds of the sale at prevailing market rates." However, table 3, *supra*, shows that almost 99.96 percent of petitioner's proceeds from the sale of participations were immediately used to buy participations from petitioner's trading partners. Table 6, *supra*, shows that petitioner's purchases resulted in a reduction in petitioner's cash flow. The only significant benefit petitioner received from the transactions was the tax loss deduction, which generated the net operating loss carrybacks, which in turn generated the tax refunds that led to the instant case (see n. 6, *supra*). Kordis testified that he was not aware of any benefits other than the tax refunds (and what petitioner could earn by investing the tax refunds) when petitioner decided to enter into the December 31, 1980, transactions. We conclude, and we have so found, that

claimed deduction in the context of the instant case (see, e.g., secs. 183(a) and 165(c)(2) for situations where this purpose might be conclusive)[10], but it does require us to scrutinize the record with particular care. *Joseph E. Widener, Trust No. 5* v. *Commissioner, 80 T.C. 304, 310 (1983).*[11]

In *Widener*, stocks in different corporations were traded between two related trusts. The dispute was as to whether the relationship between the two trusts was such that the transactions "changed the flow of economic benefits from the stocks sold." 80 T.C. at 313. We held that they did, and allowed each trust to deduct its losses. In the instant case, the parties to the transactions are completely independent of each other. The dispute is as to whether the exchanged assets are sufficiently different from each other to warrant treating petitioner's losses as having been realized.

the generation of the tax loss deduction was the sole motive for the transactions in dispute.

[10] We emphasize that we are not, in the instant opinion, limiting the effect of our statements in "shelter" opinions, "family trust" opinions, and other opinions regarding the effect of taxpayers' motives. In the instant case, the December 31, 1980, transactions were bona fide; they had nontax economic consequences (see table 6, *supra*). In the instant case, although the December 31, 1980, transactions were tax-motivated, they were merely the disposition of parts of assets that had previously been acquired by petitioner in the ordinary course of business in transactions entered into for profit. In the instant case, the taxpayers had already suffered economic losses which were unrealized for tax purposes until December 31, 1980; the December 31, 1980, transactions merely were realizations of these losses for tax purposes (see tables 4 and 5, *supra*).

[11] For example, we recognize that institutions wishing to engage in mortgage loan exchanges might consider understating fair market values in order to maximize their claimed current loss deductions. In the instant case, respondent's counsel stated at trial that he does not challenge the fair market values that petitioner and its trading partners asserted in the disputed transactions and, based on that concession and on the unchallenged evidence describing how the fair market values were determined, we have found that each of the transactions was at then-current fair market values. Under the circumstances, we deem inappropriate the implications of respondent's proposed finding of fact that "Petitioner's interest in valuing the mortgage participation packages exchanged was not adverse to the interest of the other savings and loan institutions * * *".

The loan participations are not fungible, unlike cash (see *Owens* v. *Commissioner*, 568 F.2d 1233, 1240 (CA6, 1977), affg. on this issue 64 T.C. 1 (1975)), or shares of stock of the same class in a given corporation (see *McWilliams* v. *Commissioner*, 331 U.S. 694, 702 (1947)). The underlying securities and the obligors on the loans differed one from another. The claimed losses were the market economic losses that petitioner had in fact suffered as a result of changes in interest rates. Actual collections on these loan participations after December 31, 1980, the date of the transfers, did not achieve the equality anticipated at the time of the transfers. (See table 6, *supra*.) The transfers clearly did change the flow of economic benefits from the loan participations.

In addition, before the December 31, 1980, transactions petitioner owned real estate mortgage loans. After these transactions petitioner owned (1) real estate mortgage loans diminished by 90-percent participations and (2) 90-percent participations in other real estate mortgage loans. Ownership of participations in loans has a number of characteristics that differ from ownership of entire loans. (See our findings, *supra*, as to administrative advantages and burdens associated with loan participations (slip op. at 14-15) and diminshed liquidity of loan participations (slip op. at 18).)

We conclude that petitioner realized and sustained the claimed losses in 1980, that petitioner is required to recognize these losses for 1980, and that petitioner is entitled to deduct these losses for 1980.

Realization and Recognition

Respondent contends that "The resolution of this case rests largely upon the application of Treas. Reg. § 1.1001-1(a)[12]

[12] Section 1.1001-1(a). Income Tax Regs., provides, in pertinent part, as follows:

Sec. 1.1001-1. Computation of gain or loss.

which limits the realization of gain or loss under section 1001 to transactions in which property is exchanged for 'other property differing materially either in kind or in extent' ".

The first sentence of this section of the regulation may be read as providing that income or loss is sustained if the income or loss is realized, and if this realization occurs from an "exchange of property for other property differing materially either in kind or in extent". The regulation could have, but does not state that this is the only way in which income or loss is sustained.[13] However, respondent reads that sentence as

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(a) *General rule*. Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized.
* * *

[13] Respondent draws our attention to Treas. Regs. 45, Art. 1563 (1920 ed.), which interprets section 202 of the Revenue Act of 1918 (see sec. 1405 of the Act, 40 Stat. 1151), Pub. L. 65-254, 40 Stat. 1057, 1060. Art. 1563 provides, in pertinent part, as follows:

> Art. 1563. Exchange of property. — Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (*a*) that is essentially different from the property disposed of, and (*b*) that has a market value. In other words, both (*a*) a change in substance and not merely

restricting "the occurrence or realization to situations where exchanged property differs materially in kind or extent." This appears to be equivalent to the converse of the language that is actually in the regulation.[14]

> in form, and (*b*) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value.

We note that this regulation explicitly states that there cannot be realization unless there is "a change in substance", and implies that a change in substance can only come from a conversion "into cash or into property (*a*) that is essentially different from the property disposed of". The present regulation (n. 12, *supra*) omits any statement that there cannot be a realization unless there is a change in substance. Since respondent changed this part of the language of the regulation, one may reasonably infer that respondent intended to change the meaning of the regulation. See *Zuanich* v. *Commissioner*, 77 T.C. 428, 443 n. 26 (1981). Since the change in the language is to omit in the current regulation, the earlier regulation's relatively clear statement that realization requires an essential difference between the property acquired and the property disposed of, it may fairly be concluded that respondent has eliminated this essential-difference requirement.

[14] For an illustration of the danger of assuming that converses are equivalents, see the following colloquy from "A Mad Tea-Party":

> The Hatter opened his eyes very wide on hearing this; but all he *said* was "Why is a raven like a writing-desk?"
> "Come, we shall have some fun now!" thought Alice. "I'm glad they've begun asking riddles — I believe I can guess that," she added aloud.
> "Do you mean that your think you can find out the answer to it?" said the March Hare.
> "Exactly so," said Alice.
> "Then you should say what you mean," the March Hare went on.
> "I do," Alice hastily replied; "at least — at least I mean what I say — that's the same thing, you know."

Our disagreement with respondent's conclusion does not rest on whether his regulation should be given the interpretation for which he contends. Rather, assuming that respondent is correct in his interpretation of his regulation, we conclude that the property petitioner acquired differs "materially * * * in kind" from the property petitioner transferred. We conclude, further, that the cases and concepts to which respondent directs our attention either are distinguishable or support petitioner's conclusion.

In support of respondent's interpretation of the regulation, respondent cites a series of cases, the best known of which is *Eisner* v. *Macomber*, 252 U.S. 189 (1920), in which courts have held that there was no taxable income from a transaction that left the stockholder with essentially the same position that the stockholder had in a corporation before the transaction in question. See *Towne* v. *Eisner*, 245 U.S. 418 (1918); *Weiss* v. *Stearn*, 265 U.S. 242 (1924).[15]

Respondent devotes a substantial portion of his brief to the history of predecessor statutes to section 1001, beginning with section II; B of the Tariff Act of 1913, Pub. L. 63-16, 38 Stat.

"Not the same thing a bit!" said the Hatter. "Why, you might just as well say that 'I see what I eat' is the same thing as 'I eat what I see'!"

"You might just as well say," added the March Hare, "that 'I like what I get' is the same thing as 'I get what I like'!"

"You might just as well say," added the Dormouse, which seemed to be talking in its sleep, "that 'I breathe when I sleep' is the same thing as 'I sleep when I breathe'!"

"It *is* the same thing with you," said the Hatter, and here the conversation dropped, and the party sat silent for a minute, while Alice thought over all she could remember about ravens and writing-desks, which wasn't much.

Dodgson, C.L., "The Complete Works of Lewis Carroll" (Alice's Adventures in Wonderland), pp. 75-76 (Modern Library ed.).

[15] We may pass over the irony that respondent now relies on cases in which he had earnestly argued that taxpayers had realized gains — and should be currently taxed on them — even though the taxpayers had received only proportionate stock dividends. In the instant case, the shoe appears to be on the other foot.

114, 167.[16] Various nonrecognition provisions begin in 1921 and continue through the Revenue Acts of 1926, 1928, 1932, 1936, and 1938, and in the Internal Revenue Codes of 1939 and 1954. Respondent summarizes his position as follows:

> In limiting the realization of gains and losses to exchanges involving materially different property, Treas. Reg. § 1.1001-1(a) is a vestige of the prior regulations and early Revenue Acts and reflects a position that gain or loss arises upon a change in the substance, not merely in the form, of the taxpayer's property. In general, sections 165 and 1001 require that gain or loss be realized by a specific event involving either a conversion or exchange of property. The requirement embodied in Treas. Reg. § 1.1001-1(a) that a conversion or exchange take place before gain or loss is sustained implies that a material change in the taxpayer's property is necessary before a realization of gain or loss occurs under section 1001.

Respondent claims that his position is supported by *Shoenberg* v. *Commissioner*, 77 F.2d 446 (CA8 1935), affg. 30 B.T.A. 659 (1934), and *Horne* v. *Commissioner*, 5 T.C. 250 (1945).

In *Horne*, for the conceded purpose of establishing a tax loss (5 T.C. at 251), the taxpayer sold a certificate representing his membership (or "seat") in the New York Coffee and Sugar Exchange, Inc. Eight days before the sale, in order to assure uninterrupted membership in the exchange and in the use of the exchange's facilities, he bought another certificate

[16] Section II; B of the Tariff Act of 1913 provides, in pertinent part, as follows:

> B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from * * * dividends, * * * or gains or profits and income derived from any source whatever * * *.

that differed from the first only by identifying number on the certificate. Respondent contended in *Horne* that the wash sales provision (sec. 118, I.R.C. 1939) applied. We rejected that argument (5 T.C. at 253-254). Nevertheless, we concluded that the claimed deduction must be disallowed, following and quoting extensively from *Shoenberg* and summarizing the latter case's teaching as follows (5 T.C. at 254):

> Underlying all of the loss deduction provisions of the statute is the concept of a financial detriment actually suffered by the taxpayer. Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense. That principle was thoroughly expounded by the court in *Shoenberg* v. *Commissioner* (C.C.A., 8th Cir.), 77 Fed. (2d) 446, affirming 30 B.T.A. 659; certiorari denied, 296 U.S. 586. There the taxpayer, for the purpose of establishing a tax loss, sold shares of stock through a broker at less than their cost and at the same time had the broker purchase a like number of the same shares for a wholly owned corporation. After the expiration of 30 days he then had the corporation transfer the shares back to him. In sustaining our disallowance of the loss deduction claimed the * * * [Court of Appeals] said:
>
> > Among the "transactions" or "identifiable events" which may operate to realize and fix a loss, the most commonly occurring is a sale of the property. Here there was an actual sale of these shares, and, if our examination must stop with that sale, this loss is conclusively shown. The questions here are whether we can consider the entire situation which comprehends this sale, the purchase by the Globe Investment Company and the sale by it to the taxpayer; and, if we can, the effect thereof upon the above loss as being a deductible loss.

In our penultimate paragraph in *Horne*, we stated as follows (5 T.C. at 255-256):

> Putting aside other considerations, the persuasive fact is that after consummation of the plan which petitioner had put into operation eight days previously he stood in exactly the same position as before, except that he was out of pocket $100, the difference between what he paid for his new certificate and what he received for his old one. One "seat" was exactly like another. As to how the $100 should be treated for tax purposes we are not now required to decide. Petitioner never divested himself of the rights which he enjoyed by reason of his membership in the exchange, and never intended to do so. Although he went through the form of purchasing one certificate and selling another, the result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by section 112(b)(1) of the Internal Revenue Code [of 1939[17]].

In *Shoenberg*, the taxpayer, through his wholly owned corporation, was at all times in total control of shares of stock, indistinguishable from each other, and at the end of a short period of time was exactly where he started. In *Horne*, the taxpayer's position with respect to the asset, i.e., the exchange membership represented by both certificates, never change.

In the instant case, in contrast, petitioner exchanged participations in some loans for participations in other loans. Although the loans were similar, there were important differences. Specifically, the loans had different obligors and were secured by different pieces of realty. The subsequent history of payments on the loans (see table 6, *supra*) shows that the transactions were real, not feigned, and that the assets received were not the same as the assets given up. In the instant case (unlike *Shoenberg* and *Horne*), when the

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[17] In the instant case, respondent expressly concedes the inapplicability of sec. 1031, the successor to sec. 112(b)(1), I.R.C. 1939.

smoke cleared away petitioner was left with assets that were different (and performed differently) from what petitioner had at the start. Thus, application of the principle of *Horne* and *Shoenberg* to the December 31, 1980, transactions leads us to conclude that the property is materially different, and petitioner is entitled to the claimed deductions.

Both sides urge us to be guided by *Hanlin* v. *Commissioner*, 38 B.T.A. 811 (1938), affd. 108 F.2d 429 (CA3 1939). In *Hanlin* we applied the wash sales provision, section 118 of the Revenue Act of 1932,[18] to three sets of transactions. We held that municipal bonds of the same obligor (Philadelphia) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 813-818. We held that Federal Land Bank bonds of the same obligor (Omaha Federal Land Bank) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 818-819.

However, we also held that bonds of the St. Louis and Wichita Federal Land Banks were not substantially identical to bonds of the Louisville Federal Land Bank. 38 B.T.A. 819-820. We rested our decision on the difference in obligors and the difference in assets underlying the promises of the different obligors. The Circuit Court of Appeals for the Third Circuit affirmed our conclusions as to all three sets of securities except that, with regard to the St. Louis, Wichita, and Louisville Federal Land Banks, the Circuit Court of Appeals focussed more on the differing underlying securities than on the differing obligors. 108 F.2d at 431.

In the instant case, the obligors are different and the underlying securities are different. The *Hanlin* standards lead us to conclude that the mortgage participations that petitioner acquired differ materially from the mortgage participations that petitioner transferred.

Respondent insists that the *Hanlin* criteria support his position in the instant case. He points out that the Circuit Court

[18] In the instant case, respondent expressly concedes the inapplicability of sec. 1091, the successor to section 118 of the Revenue Act of 1932.

of Appeals in *Hanlin* focussed on the geographic differences between farmland near Wichita and farmland near Louisville, and directs our attention to the fact that "The geographical variations in risks of farm property which were critical to the decision in *Hanlin* are not present in this case, which involves residential real estate." Respondent overlooks the fact that *Hanlin* involved Federal Land Banks, each of which was at least secondarily liable on the debts of the others (108 F.2d at 431), while the instant case involves individual borrowers who apparently are each liable on only their own obligations. Respondent also overlooks the fact that, in *Hanlin*, each bond was secured by a mass of mortgages, so that only a regional disaster could affect the security of the bonds. Thus, in *Hanlin*, the courts focussed on regional differences. In the instant case, each obligation apparently is secured by one residential property, so that a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obligations. We conclude that petitoner's position in the instant case is stronger than the position that the taxpayer in *Hanlin* took with respect to the bonds of the St. Louis, Wichita, and Louisville Federal Land Banks.

Mass Assets

Respondent argues that because the mortgage loans were sold in packages, they should be treated and valued as "mass assets" (rather than individually) as were assets in *United Mercantile Agencies, Inc.* v. *Commissioner*, 23 T.C. 1105 (1955), modified as to other issues sub nom. *Drybrough* v. *Commissioner*, 238 F.2d 735 (CA6 1956), and similar cases in other contexts, including *Tomlinson* v. *Commissioner*, 58 T.C. 570 (1972), affd. 507 F.2d 723 (CA9 1974); *Marsh & McLennan, Inc.* v. *Commissioner*, 51 T.C. 56 (1968), affd. 420 F.2d 667 (CA3 1969); *Manhattan Co. of Virginia, Inc.* v. *Commissioner*, 50 T.C. 78 (1968); *Westinghouse Broadcasting Co.* v. *Commissioner*, 36 T.C. 912 (1961), affd. 309

F.2d 279 (CA3 1962); *Boe* v. *Commissioner*, 35 T.C. 720 (1961), affd. 307 F.2d 339 (CA9 1962).

Petitioner stresses the importance of the different underlying assets and different obligors.

In *United Mercantile*, the taxpayer bought a mixed aggregate of claims from the liquidators of four insolvent banks. We held as follows (23 T.C. at 1117):

> In the instant case apportionment [of a purchase price among each of the claims purchased] would be wholly impractical. In each purchase United acquired hundreds of differing items, each having a highly speculative value if any value at all. Only years of attempting to collect on the various items would disclose which were worthless, the amount collectible on others, and whether the overall purchase would result in a gain or loss.
>
> Respondent argues that as United's bid was influenced by whether the individual debtors were listed in the telephone books, by competitive bids which were made either on individual items or groups of individual items, and by information furnished by the liquidator concerning various items, there was a practical basis for allocation. We disagree. While this information was useful in determining an aggregate bid price, where the number of items involved would tend to balance out errors in estimates, it would not constitute a proper, rational, or reasonably accurate basis for allocating to each individual item a part of the cost. Under the circumstances, we think United properly recovered its cost before reporting a profit. *Webster Atwell*, 17 T.C. 1374 [1952] * * *; *Inaja Land Co., Ltd.*, [9 T.C. 727 (1947)] * * *; *William T. Piper*, [5 T.C. 1104 (1945)]; *John D. Fackler*, 39 B.T.A. 395 [1939].

In the instant case, each of the participations that petitioner sold had an easily determinable basis and sale price and each of the participations petitioner bought had an easily determinable cost. (See table 4, *supra*.) Consequently, if the rationale of *United Mercantile* is to be a guide to the instant case, then its guidance is that the factual setting of the instant case requires us to hold here for petitioner.

In *Tomlinson* and in *Marsh & McLennan*, we (and the respective Courts of Appeals) held that the insurance expirations and loss experience records could not give rise to amortization deductions or business loss deductions on the records in those cases because (1) these intangibles were too closely related to nondeductible and nonamortizable goodwill, (2) even if severable from goodwill, no useful life had been established for the intangibles, and (3) no separate bases had been established for the individual expirations. None of the factual elements that we (and the respective Courts of Appeals) held to be critical in *Tomlinson* and in *Marsh & McLennan* are present in the instant case. The *Tomlinson* and *Marsh & McLennan* criteria lead to a holding for petitioner in the instant case.

In *Manhattan Co.*, we held that it was possible to apportion the taxpayer's cost of the acquired intangibles between customer lists (75 percent) and goodwill (25 percent), and to determine the useful life of the customer lists with reasonable accuracy (5 years); we rejected the taxpayer's effort to allocate the cost among the separate customers. Although the result in *Manhattan Co.* is different from that in *Tomlinson* and in *Marsh & McLennan*, the criteria appear to be the same. Our conclusion in the instant case also is the same; those criteria lead to a holding for petitioner in the instant case.

In *Westinghouse* and in *Boe*, we held that the customer service contracts there involved could not give rise to amortization deductions because (1) no separate bases had been established for the individual contracts and (2) no useful life had been established for the mass of the contracts. The Court of Appeals in *Boe*[19] agreed, but as an alternative concluded

[19] This issue was not appealed in *Westinghouse Broadcasting Co.* v. *Commissioner*, 36 T.C. 912 (1961), affd. 309 F.2d 279 (CA3 1962), and the Court of Appeals did not comment on this issue.

that the taxpayers had not established any separation between the contracts and nonamortizable goodwill. The criteria of *Westinghouse* and *Boe* also lead to a holding for petitioner in the instant case.

Thus, respondent's mass asset theory does nothing to advance his contentions, and all the cases he cites support petitioner's position in the instant case.

As in *Smith* v. *Commissioner*, 78 T.C. at 385-389, respondent is asking us to create a nonstatutory wash sale doctrine.

Our problem in accepting respondent's position is analogous to that we faced in *Smith* dealing with the proper tax treatment of silver futures "straddle"[30] trading on the Commodity Exchange.

In *Smith*, we stated as follows (78 T.C. at 387-389):

> Respondent's real, if obliquely articulated, objection, it seems to us, is that it is unfair to let petitioners recognize their losses because they knew ahead of time that there would likely be sufficient unrealized gain in their short July 1974 legs to borrow against so that they would not have to suffer any economic discomfiture on the switch. We might be more sympathetic with respondent's argument if in fact petitioners were guaranteed to have an exact offsetting unrealized gain available on August 9. However, here, they were not so assured. Contracts in different delivery months could, and in fact, did, show varying relative prices during the course of petitioners' straddles trades. While the actual pricing differences may have been small considering the size of petitioners' investments, we are not prepared to say such differences were de minimis. For us to draw a line, here, by saying that investments in these different assets must be integrated for tax purposes because their prices travel too much in tandem, simply begs the question: How nearly parallel is too nearly parallel? If platinum and gold futures prices travel roughly in tandem, are we to integrate a straddle in opposing platinum and gold futures? If the prices of certain utility stocks travel in a parallel fashion, are we to integrate a long position in utility A stock with a short position in utility B stock? A little reflection shows that straddles may be maintained in almost anything.

[30] In *Smith* v. *Commissioner*, 78 T.C. 350, 355 (1982), we defined a commodity straddle as simultaneous holding in a long position in one delivery month and a short position in another delivery month.

The complexity of enunciating a theory defining which investments are too nearly parallel is demonstrated by section 1092, added to the Code by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, sec. 501, 95 Stat. 323. Section 1092 sets up various rebuttable presumptions regarding what positions are "offsetting" for purposes of applying the new straddle provisions. Section 1092(c)(3)(A) states five statutorily defined factors which indicate a straddle in offsetting positions and authorizes the Secretary to promulgate regulations naming further factors (and thereby creating further rebuttable presumptions) which indicate offsetting positions. We do not believe it is within the province of this Court to attempt to draft our own novel straddle integration provision.

We conclude that in the instant case both a nonstatutory wash sale doctrine and the step transaction doctrine are inappropriate to achieve respondent's result. In the past, nonstatutory wash sale consequences have resulted in cases where a party has failed to completely relinquish an economic investment in the same or a substantially identical asset. *McWilliams* v. *Commissioner*, 331 U.S. 694 (1947); *Horne* v. *Commissioner*, 5 T.C. 250 (1945). In the instant case, after the switch, petitioners were not holding the same assets, March 1974 and December 1974 futures, but were instead holding May 1974 and September 1974 futures. These new positions were not substantially identical assets for purposes of the statutory wash sale provision (*Corn Products*

> *Refining Co.* v. *Commissioner, supra,* 16 T.C. [395] at 399-400 [1951], affd. on this issue 215 F.2d [513] at 516-517 [(CA2 1954)]), nor were they substantially identical for any other wash sale approach. *Harriss* v. *Commissioner, supra* [44 B.T.A. 999 (1941), affd. 143 F.2d 279 (CA2 1944)]; *Valley Waste Mills* v. *Page, supra* [115 F.2d 466 (CA5 1940)]. We fail to see how the mere simultaneous holding of a short July 1974 position throughout this period changes the result. Accordingly, a nonstatutory wash sale approach does not require the integration of petitioners' losses. [Fn. ref. omitted.[21]]

In the instant case, future collections on the loan participations sold could not be expected to coincide in dollar amount to collections on the participations purchased but would almost certainly exceed the fair market values of the loan portfolios as of December 31, 1980. As reflected in our findings, most loans do not run to their stated maturity dates. Bad debt losses occur. Discounting to the "present value" of future earnings, necessarily considered in determining fair market value, makes it likely that actual collections will exceed the new basis of loan portfolios obtained if the losses are recognized in these transactions. Petitioner would thereby achieve a present loss deduction and deferred gain recognition. This result alone, however, does not compel judicial preclusion. See, e.g., *Smith* v. *Commissioner*, 78 T.C. at 389.[22] See also *Joseph E. Widener, Trust No. 5* v. *Commissioner*, 80 T.C. at 310.

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[21] The parties in the instant case each presented expert witnesses who differed as to the significance of swapping individual residential loans or loan pools to the economic positions of the swapping institutions. The testimony exemplifies the numerous choices to be made in deciding whether a variable precludes or creates substantial identity or material difference.

[22] Respondent relies on *Smith* v. *Commissioner*, 78 T.C. 350 (1982), in his analysis of the Sale v. Exchange dispute, discussed *supra*. We agree with his reliance on *Smith* for that aspect of the instant case. However, *Smith* is a sword with several edges. The edge which is relevant on the aspect of the case dealt with at this point in the opinion's text cuts against respondent.

RAP and GAAP

The parties have discussed the various pronouncements of the FHLBB and have presented expert testimony about what is or ought to be the required or permissible treatment of the December 31, 1980, transactions under GAAP.

The knowledgeable experts that the parties brought forth did "assist the trier of fact to understand the evidence or to determine a fact in issue", in accordance with Rule 702, Fed. R. Evid. However, it is unclear whether under GAAP petitioner must report losses on the December 31, 1980, transactons, or must not report losses on these transactions, or may elect to report or not as it wishes. It is also unclear as to what effect GAAP should have on tax reporting in the context of the instant case. See, e.g., *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 577 (1978).

As to the effect of Memorandum R-49, we note that "it has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." (Citations omitted.) *Bellefontaine Federal Savings & Loan Association* v. *Commissioner*, 33 T.C. 808, 811-812 (1960). As to the significance of a nontax agency's understanding of tax law, see *Graff* v. *Commissioner*, 74 T.C. 743 (1980), affd. 673 F.2d 784 (CA5 1982).

As a result of the foregoing, we have examined the requirements of section 1001 in the context of the tax laws and the tax precedents that the parties have relied on — the determinations of the FHLBB and the accounting profession have neither led us to, nor away from, the conclusions we have reached.

Section 165

Respondent's final contention is that petitioner is not entitled to a loss deduction under section 165(a). Respondent states as follows:

> A transaction involving legally enforceable arrangements between legitimate entities may lack substance

and fail to achieve the desired tax effect because it is purposeless apart from tax motivations. *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *Davis* v. *Commissioner*, 585 F.2d 807 (6th Cir. 1978) [, affg. 66 T.C. 260 (1976)]; *Goldstein* v. *Commissioner*, 364 F.2d 734 (2d Cir. 1966) [, affg. 44 T.C. 284 (1965)].

In contrast to the cited cases, in the instant case—

(1) By December 31, 1980, petitioner had already suffered the real economic losses in transactions originally entered into for profit.

(2) On December 31, 1980, petitioner really did dispose of and acquire the loan participations; there were no limitations on the transfers that would cause petitioner to retain benefits or burdens on the loan participations it disposed of, or require shifting of benefits and burdens on the loan participations it acquired.

(3) The December 31, 1980, transactions were real transfers of real assets to and from unrelated parties.

We conclude that petitioner's realized, recognizable losses are deductible under section 165.

Respondent has drawn our attention to a recent opinion in *Centennial Savings Bank FSB* v. *United States* (N.D. Tex. Jan. 22, 1988), in which the taxpayer lost on a record apparently essentially similar to that in the instant case. In *Centennial*, the court concluded that the transactions there in dispute were exchanges and not merely sales (we have come to the same conclusion as to the December 31, 1980, transactions in the instant case), that the parties to the transactions there in dispute paid little or no attention to individual characteristics of the loans there involved (we have come to the same conclusion as to the December 31, 1980, transactions in the instant case), and that no loss was realized as a result of the transactions there is dispute.

We note that the *Centennial* opinion relies on *Schoenberg* v. *Commissioner*, *supra*, and *Eisner* v. *Macomber*, *supra*. In

Eisner v. *Macomber*, the taxpayer was held not to have income from proportionate stock dividends which left her in the same relationship to the corporation that she had been in before the distribution. In *Schoenberg*, we summarized the situation as follows (30 B.T.A. at 661):

> At the start of the series of steps the taxpayer had a certain number of shares in various companies; at the close he had precisely the same number of shares in the same companies.

In the instant case, petitioner started with real estate mortgage loans; after the December 31, 1980, transactions petitioner had (1) those loans diminished by 90-percent participations and (2) 90-percent participations in other loans. The different groups of loans had different obligors, had different collateral, and performed differently. The instant case is significantly different from the cases relied on in the *Centennial* opinion.

The *Centennial* opinion stresses the taxpayer's compliance with Memorandum R-49 and concludes that "if Centennial claims the benefits of alleged business purposes for entering into the R-49 transaction, it must also bear the burdens. It cannot have its cake and eat it too." As we have pointed out, the requirements of RAP do not control the tax laws. We do not believe it is appropriate to judicially modify the tax laws in order to offset (or to enhance) the effects of benefits and burdens that may be dispensed by regulatory agencies. See *Bellefontaine Federal Savings & Loan Association* v. *Commissioner*, *supra*; *Graff* v. *Commissioner*, *supra*. We take the tax law as we find it.

We disagree with part of the analysis in *Centennial* and with the conclusion in *Centennial*.

We hold for petitioner. Because of a concession by petitioner (n. 1, *supra*),

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, PARKER, KÖRNER, SHIELDS, CLAPP, SWIFT, JACOBS, PARR, WELLS, and WHALEN, *JJ.*, *agree with the majority opinion.*

GERBER and RUWE, JJ., did not participate in the consideration of this case.

COHEN, *J.*, concurring: I concur in the result reached in this case and in *Federal National Mortgage Association* v. *Commissioner*, 90 T.C. ____ (filed today) (*FNMA*), that the taxpayers realized and may recognize losses on exchanges of interests in mortgage loan portfolios. I disagree with the result reached by the District Court in *Centennial Savings Bank FSB* v. *United States*, ____ F.Supp. ____, No. CA3-86-1396-H (filed January 22, 1988). The reason for my conclusion, however, differs from the analysis set forth in any of those opinions.

In this case and in *FNMA*, the Court finds that the loan portfolios that were the subject of the exchange transactions did differ materially, either in kind or extent, from each other. In *Centennial Savings Bank FSB*, the District Court concluded that the loan portfolios exchanged did not differ materially in kind or extent. It is possible, of course, to argue that these are merely permissible different conclusions reached by the respective trial judges, each of whom made findings of fact in support of his conclusion. It seems to me, however, that the correct result in these cases does not depend on such factual determinations.

My approach focuses on interpretation of section 1.1001-1(a), Income Tax Regs. As indicated in the majority opinion, that regulation could have, but does not state that income or loss is only sustained upon "exchange of property for other property differing materially either in kind or in extent" (page 29); prior regulations containing such a requirement have not been carried forward in the current regulation (footnote 13); and the converse of a true statement is not necessarily true (footnote 14). Respondent contends that the regulation means that the gain or loss realized from the ex-

change of property for other property *not* differing materially either in kind or extent is *not* treated as income or loss. I believe that the regulation deals with *computation* of gain or loss and not with whether gain or loss will be realized or recognized.

The regulation, of course, is subordinate to the statute. Section 1001(c) provides:

> (c) Recognition of Gain or Loss.—Except as otherwise provided in this subtitle, the entire amount of gain or loss, determined under this section, on the sale or exchange of property shall be recognized.[1]

The only relevant nonrecognition provisions or exceptions "otherwise provided in this subtitle" are the statutory wash sale provisions set forth in section 1031, dealing with like-kind exchanges, or section 1091, dealing with wash sales of stock or securities. The parties in this case (although not in *FNMA* or *Centennial*) agree that neither of those sections is applicable. Section 1031 expressly excludes applicability of the "like-kind exchange" rules to evidence of indebtedness. I suggest that this is an appropriate situation for applying the maxim "*Expressio unius est exclusio alterius.*" See *duPont* v. *Commissioner*, 118 F.2d 544, 545 (3d Cir. 1941); 1 Mertens, Law of Federal Income Taxation, sec. 3.17.

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[1] Section 1.1002-1(b), Income Tax Regs., promulgated under the predecessor of section 1001(c), states:

> (b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

As the majority points out, respondent is nonetheless asking that we adopt a nonstatutory wash sale provision. The majority correctly, in my view, rejects that position (pages 41-43). I would hold that, as a matter of law, there is no requirement applicable in this case that the properties exchanged differ materially in kind or in extent.

NIMS, WHITAKER, WRIGHT, and WILLIAMS, *JJ.*, agree with this concurring opinion.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 89-1036

COTTAGE SAVINGS ASSOCIATION,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Before: WELLFORD and NORRIS, Circuit Judges; and LIVELY, Senior Circuit Judge.

JUDGMENT
(Filed December 4, 1989)

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said tax court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said tax court in this cause be and the same is hereby reversed and the petition for review is granted.

Each party is to bear its own costs on appeal.

ENTERED BY ORDER OF THE COURT
Leonard Green, Clerk

/s/ LEONARD GREEN
Clerk

Issued as Mandate: March 22, 1990.

[CERTIFICATION OMITTED]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 89-1036

COTTAGE SAVINGS ASSOCIATION,
Petitioner-Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

ORDER
(Filed March 14, 1990)

BEFORE: WELLFORD and NORRIS, Circuit Judges; and LIVELY, Senior Circuit Judge.

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and less than a majority of the judges having favored the suggestion, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ LEONARD GREEN
Clerk

FEDERAL HOME LOAN BANK BOARD MEMORANDUM

R 49 LOSS NEED NOT BE RECORDED FROM 'RECIPROCAL SALES' OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS

June 27, 1980

The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½ or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal

amount of those originally sold, the purchaser should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to loss on sale of mortgage loans.

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.